Internal Revenue Service
memorandum

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to: International Examiner (Detroit)
Reginald Krajnik

from: Senior Technical Reviewer, Branch 3
Bernard T. Bress

BTB

subject: [redacted] - Informal Counsel Assistance (ICA)

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Facts: In 1982, a domestic corporation (P), owned all of the outstanding stock of a domestic corporation (S1) and a Country X corporation (FC). S1 owned all of the outstanding stock of a newly organized domestic corporation (S2).

In 1982, P had determined FC was insolvent. On [redacted], FC transferred all of its assets to S2, and S2 assumed all of the liabilities of FC. After the transfer, S2 operated the business of FC through a branch in Country X.

For its 1982 taxable year, P claimed a $[redacted] worthless stock deduction under section 165(g)(3) on its FC stock. In addition, P claimed a business expense deduction of $[redacted] under section 162 for payments P made to the creditors of FC.

On its balance sheet dated [redacted], FC had valued its fixed assets at £[redacted]. After examining the appraisal on which this value was based, an IRS engineer increased the value of FC's fixed assets by £[redacted] ($[redacted]) to £[redacted]. As a result, FC was not insolvent when it transferred its assets to S2.

Issue: Whether S2 acquired substantially all of the assets of FC solely in exchange for the voting stock of S1?

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Discussion:

A parenthetical "C" reorganization means a transaction under section 368(a)(1)(C) in which one corporation acquires substantially all of the properties of another corporation solely in exchange for all or a part of the voting stock of a corporation which is in control of the acquiring corporation (see § 1.368-2(d)(1)). In addition, other requirements such as the continuity of business enterprise must apply for the transaction to qualify as a reorganization. Under these facts, we have assumed those additional requirements have been met.

Under these facts, S2 acquired substantially all of the properties (assets) of another corporation, FC. The issue is whether S2 acquired those properties solely in exchange for all or a part of the voting stock of S1, a corporation which is in control S2, even though FC did not actually receive S1 voting stock in the exchange. We deem that S2 did acquire the assets of FC solely in exchange for S1 voting stock based on the meaningless gesture doctrine.

The tax court applied this doctrine in Lessinger v. Commissioner, 85 TC 824 (1985), and examined whether the stock exchange requirements of section 351 had been met where a shareholder transferred property to its wholly-owned corporation but did not receive any additional stock. The court concluded that whether the shareholder received additional stock made no difference where the corporation was wholly-owned. The court held that the requirements of section 351 were met even though no additional stock was issued. (See Lessinger at 836).

On appeal, the second circuit in Lessinger v. Commissioner, 872 F.2d 519 (2nd Cir. 1989) agreed that the issuance of new stock would have been a meaningless gesture and that the "exchange requirements of section 351 are met where a sole shareholder transfers property to a wholly-owned corporation even though no stock or securities are issued therefor." (See Lessinger at 522.)

Rev. Rul. 64-155 supports the Lessinger holding and provides that where X, a domestic corporation, proposes to contribute appreciated property to Y, an existing wholly-owned subsidiary, the transaction will be considered an exchange of property for stock described in section 351 even though X will not receive any additional Y shares.

In Commissioner v. Morgan, 288 F.2d 676, 680 (3rd Cir.), cert. denied 368 U.S. 836 (1961), the court, in determining that a transaction qualified as reorganization, held that the exchange requirements of sections 354(a)(1) and 356(a)(1)(B) had been met because the issuance of additional stock would have been a meaningless gesture where a corporation is already wholly-owned.

Under these facts, issuing additional S1 voting stock in exchange for the FC assets would have been a meaningless gesture because P owned [redacted] percent of S1 and FC both before and after the transfer of assets. Therefore, the exchange requirements of sections 368(a)(1)(C) and 354(a)(1) are deemed to be met even though S1 stock was not actually transferred in exchange for the FC assets.

Conclusion: This transaction constitutes a reorganization within the meaning of section 368(a)(1)(C) of the Code, because S2 acquired substantially all of the properties (assets) of FC solely in exchange for all or a part of the voting stock of S1, a corporation which is in control of S2.

As a result, the transaction comes within § 7.367(b)-7(c)(2) of the Income Tax Regulations. If FC had earnings and profits, P will take the "all earnings and profits amount" (see § 7.367(b)-2(f) of the regulations) into income as a dividend (see section 7.367(b)-3(b)), and the foreign tax credit provisions (section 78, and 901 through 908) shall apply as if such earnings and profits were actually distributed by a foreign corporation as a dividend (see section 7.367(b)-3(f)). If FC had a deficit in earnings and profits, it will carryover to S2 and will offset future earnings and profits of S2 in accordance with section 381(c)(2).